Weekly Macro & Markets View

Highlights and View

- **Democrats win both seats in the Georgia runoff giving them a slim majority in the US Senate**

  Now in control of both houses, Democrats and President-elect Joe Biden will be able to implement major parts of their political priorities, beginning with more fiscal support for households and municipalities.

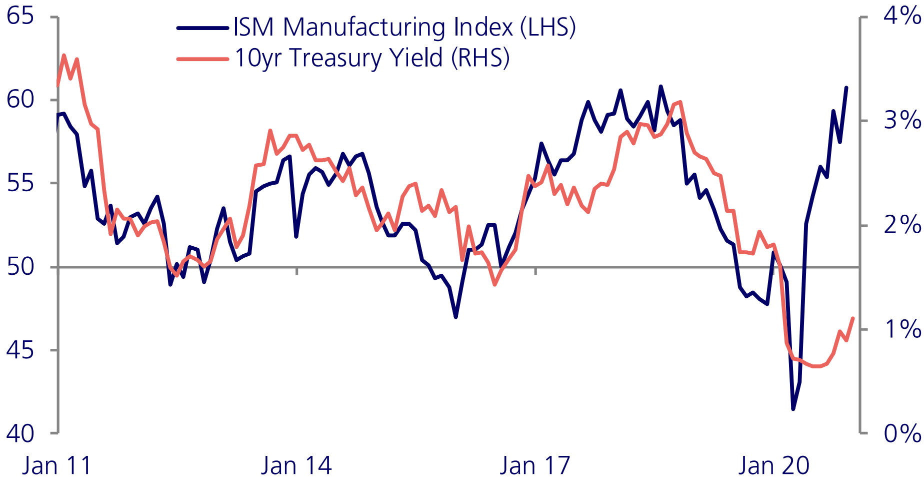
- **With additional fiscal support measures more likely US Treasury yields spike higher**

  We suspect further near term upside to bond yields is limited, with significant economic and political challenges remaining and global central banks firmly on hold.

- **Global PMIs show strong economic momentum at the end of 2020**

  The economic recovery remains intact despite a challenging pandemic situation, with sentiment and spending bolstered by policy support and positive vaccine developments.

The reflation trade is on as Democrats secure a majority in Congress



Source: Bloomberg

After a weak start into the new year, with the S&P 500 shedding more than 2% in the first few hours of trading, the stock market turned around quickly and ended the week at a new record high. Equities, and particularly cyclical stocks, gained momentum over the course of the week following the Democrats' election victory in the Georgia runoff for the remaining two Senate seats. Winning both seats gives the Democrats a slim majority in the Senate, making it much easier for President-elect Joe Biden to implement his political priorities. This makes another tranche of fiscal stimulus likely, targeted at supporting households and municipalities. Accordingly, Treasuries came under pressure, lifting longer-term yields to the highest level since March. Investors even shrugged off the turbulent events in Washington culminating in the occupation of the Capitol. Though calm has been restored, the scenes reflect the major challenge facing the new president in trying to unite opposing political groups in the US. Meanwhile, the economy showed solid momentum at the end of last year, with both ISM surveys signalling robust expansion. The labour market, however, is showing signs of weakness with payrolls falling by 140'000 in December, making additional fiscal stimulus under Joe Biden even more likely.

Bonds: Government bond yields spike higher on Democratic sweep

The outcome of the Senate runoff in Georgia caused US Treasury and global government bond yields to spike higher as prospects for a substantially larger fiscal stimulus package improved, dominating grim pandemic news and the US political turmoil. The 10yr Treasury yield rose above 1% for the first time since March and ended the week 20bps higher at 1.12%, partly reflecting higher real yields as inflation breakevens lagged. The curve steepened sharply, with the 2/10 Treasury spread up close to 20bps, the highest level since 2017. Yields elsewhere also rose, but not to the same extent, with the 10yr Bund yield remaining below -0.5% and UK gilt yields failing to rise above 0.3%. As more US fiscal support will likely strengthening growth prospects for 2021, the rise in Treasury yields appear justified. However, prospects for a significant and longer lasting policy shift are limited, given the slim Democratic control of the Senate. With significant headwinds to growth and inflation, rising infection rates, central banks that are firmly on hold, and elevated debt levels, we suspect that most of the move higher in yields is now behind us.

Equities: Investors start the year where they left off, driving stocks to new records

Despite surging COVID infections and political chaos in Washington, global equity markets started the year on a charge. High cash balances are being worked down, and broadening leadership trends remain dominant as evidenced in the closing stages of last year. Rising bond yields, particularly in the US, gave impetus to the global banking sector while small cap companies were also at the forefront of the rally, with the Russell 2000 index posting a gain of almost 6% last week. The broadening of performance is also visible across regions as the dominant US market ceded some relative performance. While the S&P 500 posted a gain of 1.8% over the week, it lagged almost all countries, with the UK seeing a 6.4% jump in the FTSE following its trade deal with the EU and South Korea posting gains of around 10% as heavyweights in the electronics and auto sectors surged. High cash levels, further fiscal and monetary initiatives, and suppressed interest rates provide a potent backdrop for stocks, though overbought conditions are becoming visible in the short term.

Credit: 2021 kicks off on a strong note

Credit markets were firm during the first week of 2021, as the search for yield was further intensified by optimism around additional US fiscal stimulus after Democrats gained a thin majority in the US Senate. Spreads widened initially, but we believe the driver of this was the surge in supply that is typical in January, rather than concerns around lockdowns that weighed on equity markets. European credit markets were resilient even during the equity sell-off as supply was lower than in the US. Strong investor demand was reflected in the oversubscription levels and spread tightening versus initial guidance in most new deals. The energy sector was strong, spurred by a rise in oil prices as OPEC+ agreed on further supply cuts. This allowed US high yield issuance to be dominated by energy companies. Flows into investment grade credit remained solid, especially in the US. All in all, the important first week of the year saw performance in line with our expectation that credit is likely to remain supported by a search for yield, although returns will be more muted than in the second half of 2020.

Japan: State of emergency for greater Tokyo hits consumer confidence

We have noted before that COVID-19 infection rates and fatalities in Japan are far smaller on a per capita basis compared to the Americas or Europe. However, that is not the right benchmark when you are living in Japan. The record high infections and fatalities during the current third wave, which may be linked to traditional year-end team 'bonenkai' celebrations in restaurants and bars, have caused the government to suspend the 'Go To' campaign while a state of emergency has been issued for the greater Tokyo area, which makes up about one third of nationwide GDP.

The recent speed of infections and some health-care bottlenecks have had a negative impact on consumer confidence and mobility, even though restrictions are less severe than those implemented during the first wave. As it seems likely that these restrictions will be broadened to other metropolitan hotspots, or even the whole country, economists are cutting their Q1 GDP forecasts. Though we have a favourable outlook for the year, we believe that corporate industrial production plans for January are too optimistic.

Asian PMIs: The recovery continues

December Manufacturing PMIs concluded the year positively for Asia. Taiwan stood out as a star performer with its reading shooting up to 59.4, the highest level since in 2011. Though trending lower, China's Caixin PMIs for both the manufacturing and services sectors still implied a decent expansion in economic activity ahead, though less than consensus had expected. The readings for India, Korea and Australia continued to suggest a robust recovery, and ASEAN's figures saw a modest improvement. However, a deeper dive into the PMI sub-components showed that not everything was reassuring. New orders and new export orders pulled back in almost all countries, except for Taiwan. This was masked by the strength of input and output prices, signalling upward pressure on inflation from the production side. Looking ahead, demand for Asia's exports still faces headwinds given the remaining restrictions across Europe and the US. However, the recovery in Asia's manufacturing sector should gather more momentum once mass vaccinations help curb the pandemic effectively in major parts of the world.

What to Watch

- In the US, small business optimism will reveal whether small firms have been more affected by the recent surge in infections than their larger peers while consumers are expected to remain cautious entering the new year.
- Industrial production and investor confidence data will be published for the Eurozone.
- In APAC, we expect the Bank of Korea to keep policy rates unchanged at 0.5%. Japan's Eco Watcher survey for December will reflect rising COVID-19 infections. China's December exports are likely to have decelerated but should remain robust. Australia's retail sales and housing credit for November should paint a rosy picture of the economic recovery down under. Indonesia's December trade surplus will likely be sustained given the strength of exports. India's CPI is expected to ease further in December as supply conditions slowly normalise.

Disclaimer and cautionary statement

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